

Insights

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Commentary on the economy and financial markets from Atlantic Trust's chief investment strategist.

FALSE ALARM?

A month or so ago, investors were worried that the stock market was heading for a significant correction after its sharp advance of about 70% from the bear market low a year ago to the recent high. In fact, some of the bearish pundits were pronouncing that the Fed would be tightening monetary policy in the near term and that this would lead to a premature slowing or even a truncating of the economic recovery, with disappointing earnings likely showing up later in the year.

However, based on what happened in the balance of last month, the market setback didn't turn into a real correction but could best be described as a temporary mini-correction. In fact, the S&P 500 Stock Index declined by only about 8% between the recovery high reached on January 19 and the subsequent low hit on February 8. At that point, buoyed by some stronger economic reports, the market rallied once again, recovering most of the lost ground by the end of February to where it had ended 2009.

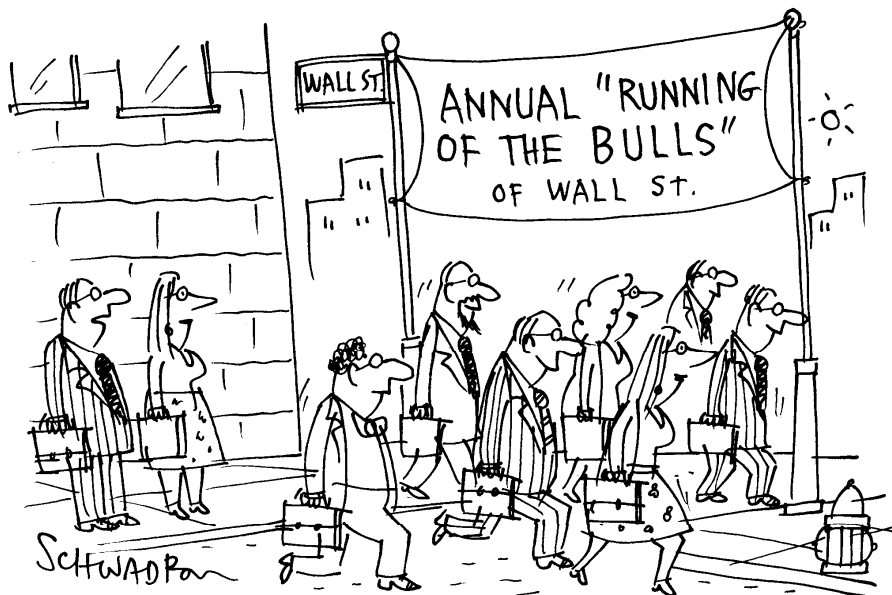
Thinking back to last year, the market hit its low on March 9, and the subsequent advance was remarkably consistent and free of any significant unnerving interruption in spite of periodic calls for a sell-off that would give back a substantial portion of the upswing. In any event, this didn't happen and stock prices essentially closed 2009 at their recovery high, posting a 26% total return for all of last year.

Considering how badly things started off in early 2009 and how favorably they went subsequently, it is hard to say that early developments provide much of an indication about what lies ahead for a year as a whole. Certainly, the stock market performed well enough over the remaining months of last year that it turned out to be a very satisfactory period for equity investors.

It should be noted that the recent market recovery reflected improving fundamentals, including better than expected fourth quarter earnings and stronger than forecast economic data, including such diverse areas as retail sales, industrial production and new orders for capital equipment. In fact, the most recent numbers have caused many economists to increase their forecasts for growth in 2010. This was then reflected in an upgrading in investor attitudes about the market. In fact, most participants now believe that the bear market ended in early 2009 and has been replaced by an upward trend in stock prices for at least the intermediate term.

THE RECOVERY QUICKENS

Looking back, the evidence suggests that an important inflection point was reached in July 2009 when the economy transitioned from recession to recovery. It wasn't all that vigorous of an upturn at the beginning, as suggested by the fact that real output grew at only a 2.2% annual rate in the third quarter, but it was a lot better than the deep



"I'M SURE IT'S SOME SORT OF PUBLICITY STUNT TO GET THE ECONOMY MOVING AGAIN."

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recession that had gripped us during the fourth quarter of 2008 and first quarter of 2009 when overall activity contracted at a rate averaging 6%.

The good news is that activity then accelerated toward the end of 2009, resulting in growth at about a 6% rate in the fourth quarter. The bad news is that about half of this pace was accounted for by a change in inventory activity, which is only a “one shot” event and doesn’t provide any positive carry into subsequent periods. As a result, we believe that it is more appropriate to think of the economy growing at a moderate 3 to 4% pace, which is essentially what we are forecasting for 2010 as a whole.

There has clearly been improvement recently in a broad swath of economic indicators, including retail sales, industrial production, new unemployment claims and durable goods orders. Even in the troubled housing sector, there has been better news with respect, permits, inventories of unsold units and affordability. As a result, it now appears that this latter key area will cease to be a drag on the economy as a whole sometime during 2010.

MASSIVE STIMULUS EFFORT

In order to combat the adverse effects of the credit crisis and the global recession and to prevent another economic depression in spite of the malaise in the financial system, nearly all of the governments around the globe put forward a massive series of fiscal and monetary stimulus actions during late 2008 and in 2009. Here in the U.S., federal spending increased sharply, which provided a cushioning for weak spending on the part of consumers and the corporate sector.

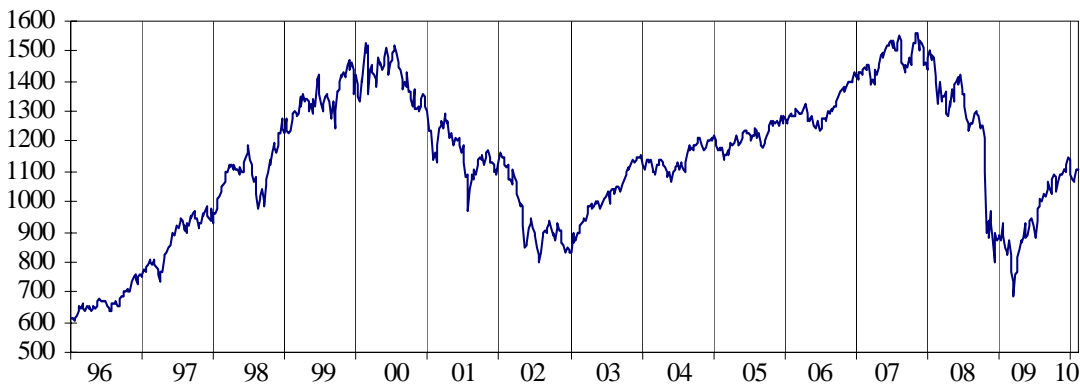
Although it clearly took longer than the government expected for the fiscal stimulus to have an effect, the magnitude of the actions was so large that it is necessarily having a significant positive impact on economic growth over the near to intermediate-term period. In fact, the federal budget deficit soared to \$1.4 trillion in fiscal 2009 or about 10% of GDP and we estimate that it will increase somewhat further in the current fiscal year to a relative level higher than ever seen before except during the peak military spending period in World War II.

Concurrently, the Federal Reserve stepped on the accelerator with regard to monetary stimulus, reducing short-term interest rates to nominal levels during all of 2009. The Fed also undertook new direct action programs to purchase large amounts of Treasury, Agency and asset-backed paper in order to reduce intermediate and longer-term interest rates, which helped to bring down mortgage rates and make housing more affordable. As a result of these actions, the yield curve on Treasury paper is now unusually steep, which is normally a harbinger of an acceleration in economic activity. However, we believe that starting as soon as the second half of 2010, the Fed will begin to implement a gradual tightening of monetary policy.

EARNINGS IMPROVE

Not surprisingly, corporate profits were adversely affected by the recession, and comparisons with a year earlier were quite weak, especially in the fourth quarter of 2008 and first quarter of 2009 when there were massive write-downs of asset values in the financial sector of the economy as well as in a few other industries. However, the weakest comparisons are now well behind and better results started to show up in the fourth quarter of 2009.

S&P 500 Stock Index (Weekly Close)
December 29, 1995 - February 26, 2010



Source: Federal Reserve Board

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Moreover, we expect that earnings comparisons will continue to be sharply higher in the first quarter of 2010, reflecting fewer asset write-downs and better operating profits. Overall, based on our expectations for the economic recovery, we expect a strong rebound in earnings in 2010, probably on the order of 25% or more versus 2009.

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